

Message Text

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PAGE 01 OECD P 26465 102006Z

14

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SUBJ: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE

REVIEW OF ICELAND, OCT 20, 1975

REF: OECD DOCUMENT EDR(75)25

1. SUMMARY AND INTRODUCTION. IN PREPARATION FOR OCT 20 EDRC REVIEW OF ICELAND, OECD SECRETARIAT HAS CIRCULATED REFDOK FOR COMMENTS. DOCUMENT REVIEWS CURRENT SITUATION AND RECENT PAST, GIVING EMPHASIS TO RAPID INFLATION, FALLING OUTPUT, CURRENT ACCOUNT DETERIORATION AND EFFECTIVENESS OF GOI POLICY RESPONSES. SECRETARIAT NOTES THAT ICELAND EXTREMELY SUSCEPTIBLE TO EXTERNAL INFLUENCES, BUT BELIEVES THAT CURRENT ILLS ALSO FUNCTION OF INADEQUATE AND INFLEXIBLE POLICY TOOLS. THUS, SECRETARIAT RECOMMENDS MODIFICATION OF FISHERIES PRICE STABILIZATION FUND (FPSF), INCREASED GOI CONTROL OF NON-BANK FINANCIAL INSTITUTIONS AND REVISION OF INCOME TAX SYSTEM. ACTION REQUESTED: (1) MISSION WOULD APPRE-

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PAGE 02 OECD P 26465 102006Z

CIATE BY OCT 19 COMMENTS ON SECRETARIAT'S ANALYSIS

AS WELL AS QUESTIONS THAT COULD USEFULLY BE POSED DURING EDRC REVIEW; (2) FOR REYKJAVIK: MISSION WOULD WELCOME EMBASSY COMMENTS, ESPECIALLY WITH REFERENCE TO NATURE OF SECRETARIAT'S POLICY RECOMMENDATIONS.

2. BACKGROUND: DOMESTIC DEMAND CONTINUED TO RISE IN 1974, ACCOMPANIED BY ACCELERATION OF PRICE INFLATION TO ANNUAL RATE IN EXCESS OF 40 PERCENT IN 1974 AND INCREASING TO 50 PERCENT IN 1975. AT THE SAME TIME, DOMESTIC OUTPUT GREW IN 1975 AT ABOUT HALF THE 1974 RATE. CURRENT ACCOUNT DEFICIT REMAINS LARGE AND WHILE STRONGLY INFLUENCED BY EXTERNAL FACTORS (SUCH AS OIL PRICE INCREASE), SECRETARIAT VIEW IS THAT DOMESTIC DETERIORATION CONTRIBUTED IN NO SMALL MEASURE TO EXTERNAL IMBALANCE AND CONSEQUENT INCREASE IN EXTERNAL DEBT. SECRETARIAT SEES 50 PERCENT INFLATION RATE AS CENTRAL PROBLEM, AND BELIEVES THAT ANTI-INFLATION POLICIES ADOPTED THIS YEAR WILL NOT THEMSELVES BE SUFFICIENT TO RESOLVE THE PROBLEMS FACING THE GOI.

3. SHORT-TERM PROSPECTS: FOR REMAINDER OF 1975, BOTH DEMAND AND OUTPUT ARE EXPECTED TO FALL SUBSTANTIALLY. CURRENT ACCOUNT DEFICIT, WHILE IMPROVING, IS LIKELY TO BE LARGE AND REMAINS MAJOR PROBLEM. CONTINUED WEAKNESS IN DOMESTIC DEMAND SHOULD HOLD DOWN VOLUME OF IMPORTS, AND IT IS LIKELY THAT GOI FORECAST OF 7-1/2 PERCENT DROP IN IMPORT DOLLAR VALUE WILL BE ACHIEVED. IMPROVEMENT IN EXPORTS DEPENDS ON REVIVAL OF FOREIGN DEMAND, PROSPECTS FOR WHICH ARE SEEN AS UNCERTAIN, AND SECRETARIAT VIEWS GOI ESTIMATE OF 7-1/2 PERCENT VOLUME INCREASE AS OPTIMISTIC. FOR 1976, IMPORT DEMAND WILL REMAIN WEAK ON THE ASSUMPTION THAT WAGE INCREASES ARE MODERATE AND DEMAND MANAGEMENT POLICIES REMAIN RESTRICTIVE. THUS, WITH SOME INCREASE IN FOREIGN DEMAND, CURRENT ACCOUNT COULD IMPROVE SOMEWHAT EVEN IF TERMS OF TRADE DETERIORATE. PROGRESS IN REDUCING INFLATION RATE DEPENDS ON GOI ABILITY TO CONTROL WAGE INCREASES AND TO MANAGE ECONOMY IN A FASHION CONSISTENT WITH MAINTAINING VALUE OF KRONER. WITH REAL PUBLIC EXPENDITURE ASSUMED CONSTANT, AND WITH SOME INCREASE IN PRIVATE LIMITED OFFICIAL USE

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PAGE 03 OECD P 26465 102006Z

INVESTMENT, DOMESTIC DEMAND AND GNP SHOULD RISE SOMEWHAT IN 1976, RESTORING EXPECTED FALL FOR 1975.

4. POLICY CONSIDERATIONS: SECRETARIAT POINTS TO VULNERABILITY OF ICELAND TO EXTERNAL INFLUENCES, AND THUS TO NEED OF FLEXIBLE DEMAND MANAGEMENT POLICY TOOLS. FPSF ESTABLISHED TO SMOOTH FLUCTUATIONS IN FISH EXPORT REVENUES, BUT HAS NOT BEEN OPERATED SO AS TO

PRODUCE DESIRED RESULT. SECRETARIAT RECOMMENDS MODIFICATION OF FPSF TO INCREASE STABILIZATION EFFECTS OR ESTABLISHMENT OF OTHER MECHANISMS TO THIS END. ANOTHER ESSENTIAL REQUIREMENT IS FOR MORE EFFECTIVE MONETARY MANAGEMENT, AS GOI HAS NOT DEMONSTRATED THAT IT CAN CONTROL MONEY SUPPLY IN FACE OF INCREASED DEMAND FOR CREDIT. SINCE NON-BANK FINANCIAL INSTITUTIONS PLAYED MAJOR ROLE IN CREATING EXCESS DEMAND IN 1973-1974, SECRETARIAT RECOMMENDS INCREASED GOVERNMENT CONTROL OVER THEIR ACTIVITIES. SINCE, UNDER PRESENT SYSTEM, MANY GOI EXPENDITURES INCREASE WITH INFLATION RATE, AND SINCE TAX BASE IS PREVIOUS YEAR'S INCOME, GOVERNMENT EXPENDITURE AND RECEIPTS HAVE PRO-CYCLICAL BIAS WHICH HAS EXACERBATED RECENT EXCESS DEMAND PRESSURES. SECRETARIAT SUGGESTS MODIFICATION OF SYSTEM TO INCREASE FLEXIBILITY AND TO REDUCE BIAS.

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